



**APPEALS  
INDUSTRY SPECIALIZATION PROGRAM  
COORDINATED ISSUE PAPER**

**INDUSTRY:** Retail

**ISSUE:** Heating, Ventilating, and Air Conditioning  
(HVAC) Systems ACRS and ITC

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**APPROVED:**

/s/ John F. Eckert                      9/4/92  
for **REGIONAL DIRECTOR OF APPEALS**                      **DATE**  
**MIDWEST REGION**

/s/ Donald E. Bergherm                      9/29/92  
for **NATIONAL DIRECTOR OF APPEALS**                      **DATE**

**EFFECTIVE DATE:** 10/5/92

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**SETTLEMENT GUIDELINES**

**HEATING, VENTILATING AND AIR CONDITIONING (HVAC)  
SYSTEMS ACRS AND ITC**

**STATEMENT OF ISSUE**

Whether heating, ventilating, and air conditioning (HVAC) units installed in retail grocery stores qualify for the investment tax credit. Also, whether HVAC units qualify as either 3 or 5 year ACRS property.

**EXAMINATION DIVISION'S POSITION**

The position of the Examination Division is that the taxpayers' central air conditioning and heating systems constitute structural components of a building unless they meet the "sole justification" test. Exam concluded that central air conditioning and heating systems which are necessary to provide customer comfort cannot meet the sole justification test merely because the primary consideration in selecting the heating and air conditioning system was the taxpayers' concern for the environmental specifications for its refrigerated display cases. Exam maintains that in the retail food industry, heating and air conditioning systems are installed not only to maintain the proper temperature for open-front refrigerated cases which display frozen and refrigerated foodstuffs, they are also installed to provide heat in the winter and store wide air conditioning in the summer. Exam contends that retail supermarket activities are not manufacturing or processing activities, therefore, to meet the sole justification test the HVAC system would have to be required exclusively to provide the temperature or humidity requirements of other machinery and provide only incidental comfort to the general store areas.

**DISCUSSION**

Treas. Reg. § 1.48-1(e)(1) provides, in part, that:

"Buildings and structural components thereof do not qualify as section 38 property. The term 'building' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example to provide shelter or housing, or to provide working, office, parking, display, or sale space...."

Treas. Reg. § 1.48-1(e)(2) provides, in part, that:

"The term 'structural components' includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes and ducts; plumbing and plumbing fixtures, such as sinks and bathtubs; electrical wiring and light fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term 'structural components' does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet the 'sole justification' test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential...."

In Piggly Wiggly Southern, 86-2 USTC ¶ 9789 (11th Circuit), affirming 84 T.C. 739 (1985); Nonacq. 1988-2 C.B. 1, the Eleventh Circuit agreed with the Tax Court's conclusion that the sole justification for installation of the HVAC units was to meet the requirements of other machinery within the meaning of the exception provided under the Regulation 1.48(e)(2) and not for the comfort of customers and employees as contended by the Government. In Piggly Wiggly, the petitioner was a supermarket chain that installed ventilation and air conditioning (HVAC) units to meet the temperature and heating requirements essential to the operation of their other refrigeration equipment. The Eleventh Circuit refused to apply the "adaptable to other operations" standard enunciated in A.C. Monk and Company, 82-2 USTC ¶ 9551 (4th

Circuit), to the context of the "sole justification" exception, since to do so would virtually read the exception out of the regulation in that almost any HVAC system installed in a building could reasonably be adapted for use by subsequent occupants.

In an Action On Decision regarding Piggly Wiggly dated September 12, 1988, Chief Counsel recommended nonacquiescence. The A.O.D. stated that the Service disagrees with the Tax Court opinion in Piggly Wiggly and will continue to litigate this issue in cases where appeal does not lie to the Eleventh Circuit.

In Albertson's v. Commissioner, T.C. Memo 1988-582, the Tax Court held that a central heating, ventilating, and air conditioning (HVAC) system used by a grocery store solely to meet temperature requirements essential to the operation of open-front refrigerated food cases is eligible for investment credit. Although the Commissioner agreed that the grocery store required HVAC systems to operate the refrigerated food cases, the Commissioner contended that the grocery store did not meet the "sole justification" test since it was alleged that a substantial reason for installing the HVAC system was to provide customer and employee comfort. The Tax Court concluded that the sole justification for the installation of the HVAC systems was to maintain the specifications recommended for proper operation of the grocer's refrigerated open-front cases.

Another issue which the Tax Court considered in Albertson's was the work incentive (WIN) credit. See Albertson's v. Commissioner, T.C. Memo 1990-153. The petitioner appealed the WIN credit issue to the Ninth Circuit and the Government cross appealed the HVAC issue.

It is the position of the Government as expressed in the A.O.D. on Piggly Wiggly Southern that where a significant reason for the installation of the HVAC is for the comfort of employees or customers the sole justification test should not apply. However, the Regulations 1.48-1(e)(2) provide, in part, that:

"Machinery may meet the "sole justification" test provided by the preceding sentence even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where such temperature or humidity requirements are not essential...."

The problem is that the taxpayers' expert testimony has convinced the Court that the HVAC units only incidentally provide for the comfort of its employees and customers.

In Publix Supermarkets, Inc. v. United States, No. 35-89 T, filed April 28, 1992, the Court of Claims denied the taxpayer's claim for investment credit on its HVAC systems. The Court

found that testimony and evidence presented at trial established that the taxpayer's HVAC systems were designed and installed to perform several functions and that at least one of these functions was to control the store's temperature and humidity for customers' and employees' comfort and health. In Publix, the Government had expert testimony to support its position.

Unless the case at issue has expert testimony for the Government that a significant reason for the installation of HVAC is for the comfort of employees or customers, the Government faces significant litigating hazards because taxpayers will continue, with their own expert testimony, to convince the Courts that their HVAC units only incidentally provide for the comfort of employees and customers.

The qualification of HVAC units in retail grocery stores for the ACRS deduction as 3 or 5 year property is dependent upon qualification as Section 38 property for investment tax credit purposes.